BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of	)	
	)	Nos. 89A-0405-JV
DAYTON HUDSON CORPORATION	)	90R-0247-JV

Appearances:

For Appellant:	James P. Kleier Attorney at Law
For Respondent:	Cody Cinnamon Counsel

O P I N I O N

This appeal is made pursuant to section 25666[1/] of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Dayton Hudson Corporation against proposed assessments of additional franchise tax in the amounts of $7,941 and $93,854 for the income years 1984 and 1985, respectively, and pursuant to section 26075, subdivision (a), from the action of the Franchise Tax Board in denying the claims of Dayton Hudson Corporation for refund of franchise tax in the amounts of $62,002, $24,244, and $162,237 for the income years 1984, 1985, and 1986, respectively.

[1/] Unless otherwise specified, all section references are to sections of the Revenue and Taxation Code as in effect for the income years in issue.

The primary issue presented is whether the Michigan Single Business Tax is a tax on income and thus not deductible. If the Michigan Single Business Tax is deductible, we must decide whether respondent may bifurcate it into deductible and nondeductible portions. We conclude that the Michigan Single Business Tax is deductible and cannot be bifurcated into deductible and nondeductible portions.

Appellant is a Minnesota corporation doing business in California. During the appeal years, appellant also did business in Michigan and was required to pay the Michigan Single Business Tax (MSBT). Appellant deducted the Michigan tax on its California franchise tax return. Respondent, after audit, disallowed the deduction, and this appeal followed.

The initial issue is whether the MSBT is nondeductible by reason of subdivision (b) of section 24345. Respondent contends that the MSBT is a tax "on or according to or measured by income," and is thus nondeductible. Appellant, on the other hand, contends that because the MSBT includes an element of cost of goods sold it is not a tax "on or according to or measured by income," and thus is deductible.

Section 24345, subdivision (b), in relevant part, provides that a deduction shall not be allowed for any state tax "on or according to or measured by income and profits paid or accrued within the income year." To determine if the tax is on or measured by income, the true nature of the tax must be determined. (Beamer v. Franchise Tax Board, 19 Cal.3d 467, 475 [138 Cal.Rptr. 199] (1977).) The statutory language, "taxes on or according to or measured by income" refers to "income" in the sense of gross income under general tax law as currently operating. (Beamer v. Franchise Tax Board, supra, 19 Cal.3d at 479.) In a manufacturing, merchandising, or mining business, gross income is not the same as gross receipts, since gross receipts must be reduced by the cost of goods sold to equal gross income. (Beamer v. Franchise Tax Board, supra, 19 Cal.3d at 477; Treas. Reg. § 1.61-3(a).) A tax on or measured by gross receipts is deductible; a tax on or measured by gross income is not deductible. (Rev. & Tax. Code, § 24345, subd. (b); MCA, Inc. v. Franchise Tax Board, 115 Cal.App.3d 185, 198 [171 Cal.Rptr. 242] (1981).) Both parties agree that the MSBT is not a tax on gross income. Thus, the real question becomes whether the MSBT is a tax measured by gross income. A review of the Michigan tax is necessary to answer this question.

The MSBT was enacted in 1975 as a replacement for several different Michigan business taxes. (Trinova Corporation v. Michigan Department of Treasury, 498 U.S. 358, 366 [112 L.Ed.2d 884] (1991).) The MSBT is a type of value added tax which differs greatly from a

normal corporate income tax in both its conception and its computation.[2/] (Trinova Corporation v. Michigan Department of Treasury, supra, 498 U.S. at 367.) To compute the MSBT, the taxpayer first determines its tax base by adding to federal taxable income compensation paid (including labor costs which are incurred as part of the cost of goods sold [hereinafter referred to as "labor cost of goods sold"]), depreciation, taxes (income and MSBT), dividends, interest, and royalties paid, carryovers and carrybacks of capital and net operating losses, and losses from partnerships, and then subtracting income from partnerships, certain capital losses, and dividends, interest, and royalties received. Once the tax base is determined, that amount is either allocated to Michigan or, if business activities are taxable in other states, apportioned using a three-factor formula. The tax base allocated or apportioned to Michigan is then adjusted by business losses, statutory exemptions, and certain capital acquisition deductions. At this point, a taxpayer may elect one of the following adjustments: (1) reduce the adjusted tax base to 50 percent of gross receipts, or (2) reduce the adjusted tax base by the percentage that compensation exceeds 65 percent of the total tax base. (1 Mich. State Tax Rptr. (CCH) ¶ 10-001, 11-115 et seq.; Kasishke, Computation of the Michigan Single Business Tax: Theory and Mechanics, 22 Wayne L.Rev. 1069 (1976).) The resulting adjusted base is then taxed at a rate of 2.35 percent.

Appellant argues that the critical inquiry in determining whether a tax is measured by income is whether the base includes cost of goods sold or a return of capital. (Beamer v. Franchise Tax Board, supra, 19 Cal.3d at 479-480; MCA, Inc. v. Franchise Tax Board, supra, 115 Cal.App.3d at 198; Robinson v. Franchise Tax Board, 120 Cal.App.3d 72, 82 [174 Cal.Rptr. 437] (1981).)

In Beamer v. Franchise Tax Board, supra, our state Supreme Court allowed the deduction of two Texas gas/oil production taxes because they were measured by total gross receipts from the sale of the minerals produced. In Beamer the amount of the Texas taxes was a specific percentage of the market value of the gas or oil, "as and when produced." Market value for gas was stated to be "the value thereof at the mouth of the well." (Beamer v. Franchise Tax Board, supra, 19 Cal.3d at 475.) The court determined that the lifting costs related to the production of the gas and oil were costs of goods sold and, because such costs were not deducted in computing the Texas taxes, the taxes were "not measured by income." (Beamer v. Franchise Tax Board, supra, 19 Cal.3d at 476-477.)

Appellant contends that, applying the holding in Beamer to the MSBT, the Michigan tax

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[2/] As explained by the Supreme Court in the Trinova case, a traditional value added tax is a tax that is based on the "increase in the value of goods and services brought about by whatever a business does to them between the time of purchase and the time of sale. . . . The value a business adds to a single product is `the difference between the value of the product at sale and the cost of goods purchased from other businesses that went into the product.'" (Trinova Corporation v. Michigan Department of Treasury, supra, 498 U.S. at 362.) Therefore, the difference between a normal corporate income tax and a value added tax is that a corporate tax is based on a portion of profit remaining after a company has provided for its orders, suppliers, and other creditors, whereas the value added tax is a much broader measure of a firm's total business activity. Thus, under a value added tax, a business entity may owe some tax even if the business is unprofitable. (Trinova Corporation v. Michigan Department of Treasury, supra, 498 U.S. at 363-364.)

is not measured by income because the base includes an item which must be deducted to arrive at gross income or, in other words, it includes an element of return of capital, i.e., labor cost of goods sold. Therefore, appellant argues, the MSBT is deductible.

Respondent argues that Beamer and subsequent court cases and State Board of Equalization opinions only addressed the situation where gross receipts, as defined by the law being reviewed, included all the costs of goods sold.[3/] Clearly, a tax which is imposed on a sale made by a manufacturer, merchandiser, or miner, and which includes all of the costs of goods sold in the base, is a gross receipts tax and, therefore, fully deductible. However, respondent argues, the MSBT includes only a portion of the cost of goods sold in the base, i.e., labor cost of goods sold, and thus, the Beamer line of cases does not provide clear guidance on this issue.

However, in determining whether a tax is deductible or nondeductible under section 24345, subdivision (b), the question is not whether the tax is a gross receipts tax or an income tax, as respondent is arguing, but whether the tax is or is not on or measured by gross income. If it is not a tax on or measured by gross income, then our inquiry ends and the taxpayer need not show whether it is a tax on or measured by gross receipts.

We conclude that appellant has correctly applied the holding in Beamer to the MSBT. The fact that the Michigan tax base includes an element of return of capital requires us to conclude that the tax is measured by something other than gross income. Therefore, we agree with appellant that the MSBT is not a tax on gross income and therefore is deductible.

This brings us to the second issue, whether respondent may bifurcate the MSBT into a deductible and a nondeductible portion. For the following reasons we agree with the appellant that the MSBT is indivisible.

Respondent argues that when the tax base includes only a portion, not all, of the costs of goods sold, the tax may not be a pure income tax, but it is also not a pure gross receipts tax and, therefore, it cannot be fully deductible. Following this line of reasoning, respondent

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[3/] In Beamer v. Franchise Tax Board, supra, 19 Cal.3d at 479, the court held that the taxes were measured by the "total gross receipts" from the sales of the minerals produced.

issued FTB Notice 90-2 on January 2, 1990,[4/] stating that it would allow taxpayers a deduction for the MSBT to the extent the tax base included labor cost of goods sold. Based upon FTB Notice 90-2, respondent disallowed appellant's deduction of MSBT for the appeal years except to the extent that the MSBT reflected labor cost of goods sold. Respondent, however, has provided no authority for its position on this issue other than its own Notice 90-2. Respondent acknowledges that no California case, either at the Board of Equalization level or in the courts, has dealt directly with this issue, but argues that its position in FTB Notice 90-2 is supported by certain State Board of Equalization opinions and other state court decisions that have dealt with hybrid tax situations.[5/] Upon review of the cases cited by the respondent we find such cases distinguishable or otherwise unconvincing. Moreover, we find that the Supreme Court decision in Trinova, supra, as discussed below, is controlling as to whether the MSBT is divisible or not.

The Supreme Court in Trinova was faced with the question of whether the three-factor apportionment formula under the MSBT violated either the Due Process Clause or the Commerce Clause. The taxpayer in Trinova wanted to establish that the MSBT could be broken into three smaller taxes, i.e., separate taxes on compensation, depreciation, and income, much like respondent's attempt to separate the labor cost of goods sold and the income components in the appeal currently before this board. By separating these tax components out of the MSBT, the taxpayer in the Trinova case hoped to establish that the compensation and depreciation elements could be assigned to one geographic location which would cause the apportionment of the tax to be unconstitutional. However, the Supreme Court rejected the taxpayer's argument stating: "The Michigan SBT [Single Business Tax], however, is not three separate and independent taxes" (Trinova Corporation v. Michigan Department of Treasury, supra, 498 U.S. at 375), but is an indivisible tax upon a different, bona fide measure of business activity, the value added.

Based upon the foregoing, we are compelled to agree with the appellant that the respondent may not bifurcate the MSBT tax. Therefore, since the Michigan Single Business Tax is deductible and cannot be bifurcated into deductible and nondeductible portions, the actions of the FTB must be reversed.

[4/] Prior to issuing FTB Notice 90-2, in Legal Ruling No. 371, respondent seemed to reject the bifurcation theory stating that "the controlling factor [to determine deductibility] is whether the specific tax imposed and for which deduction is claimed is a tax on income exclusively." (FTB LR No. 371 (Jan. 22, 1974) (emphasis added).)

[5/] Respondent maintains that unless respondent's application of FTB Notice 90-2 is unreasonable, we must follow respondent's approach. However, in our view, respondent has taken inconsistent positions under LR No. 371 and Public Notice 90-2. Public Notice 90-2 does not clarify or make reference to FTB's prior position in LR 371. Therefore, it is incumbent upon us to provide our interpretation on this matter.

O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED, AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Dayton Hudson Corporation against proposed assessments of additional franchise tax in the amounts of $7,941 and $93,854 for the income years 1984 and 1985, respectively, be and the same is hereby reversed, and pursuant to section 26077 of the Revenue and Taxation Code, that the action the Franchise Tax Board in denying the claims of Dayton Hudson Corporation for refund of franchise tax in the amounts of $62,002, $24,244, and $162,237 for the income years 1984, 1985, and 1986, respectively, be and the same is hereby reversed.

Done at Sacramento, California, this 3rd day of February, 1994, by the State Board of Equalization, with Board Members Mr. Sherman, Mr. Fong, and Ms. Scott present.

_____, Chairman

Matthew K. Fong, Member

Windie Scott*, Member

_____, Member

_____, Member

*For Gray Davis, per Government Code section 7.9.

dayton.jv